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## Employee stock ownership plans: Expanded opportunities for employers, shareholders and employees

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# Employee Stock Ownership Plans

Expanded Opportunities  
for Employers, Shareholders  
and Employees

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"Just as in 1862, when Congress passed a law to allow Americans who had very little money to own and develop up to 160 acres of land, we should now give Americans the opportunity to become owners of our growing frontier of new capital (stock). The way to do this is through laws which encourage the development of programs like ESOP."

—*Senator Russell B. Long, Chairman, Senate Finance Committee.*

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## Introduction

They have been called everything from a "highly imperfect vehicle" to "the only viable alternative to wage and price controls and state planning" to "a panacea for raising capital for the corporation." Article after article has wrestled with their advantages and disadvantages, from *Fortune* to *Harvard Business Review* to *Business Week*.

What are they? Employee stock ownership plans, better known as ESOPs.

ESOPs, unlike the traditional stock bonus plan, profit-sharing plan and money purchase plan, have the ability to borrow large sums of money because the employer company can guarantee the loan. This ability to borrow, combined with the stipulation that the plan invest primarily in qualifying employer securities, has led companies of all sizes, public and private, to take a serious look at ESOPs and their potential to raise funds for capital investment, to finance acquisitions and divestitures, and to accomplish transfers of ownership.

Companies that have decided ESOPs appeal to them include:

Ruddick Corporation	Atlantic Richfield Company
Florida Power & Light Company	Pfizer Inc.
Marathon Oil Company	Ralph M. Parsons Company
Duke Power Company	Hi-Shear Corporation
Hallmark Cards, Inc.	GENESCO Inc.
Shell Oil Company	American Telephone and
Dow Chemical Company	Telegraph Company
Comsat	

AT&T recently endorsed the concept of ESOPs by announcing one of the largest plans to date. Because the utility obviously is capital intensive and generates sizeable investment tax credits yearly, AT&T's plan will be in the form of a Tax Reduction Act stock ownership plan (TRASOP). Companies are allowed additional investment tax credit if the additional amount is contributed to a TRASOP. AT&T sees its plan as providing not only an extra benefit for its employees but also another source of equity financing.

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At Hallmark Cards, a privately owned company, an ESOP will be used by the controlling shareholders for estate planning as well as for transferring some of the ownership from the controlling shareholders to the employees of the company.

Yet, ESOPs are not for every company. For many, the disadvantages discussed later may far outweigh the advantages that ESOPs offer.

Let's take a look at the evolution of ESOPs; review some statistics about certain economic conditions that proponents of ESOPs contend these plans can reverse; discuss the various types of ESOPs, including some of the advantages and disadvantages of which companies should be aware; and discuss how ESOPs can be used by companies for more than the basic employee benefit plan....

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## History of Employee Benefit Plans

Employee benefit plans have been in existence in one form or another since 1921 when profit sharing plans and stock bonus plans were first provided for in the Internal Revenue Code. However, according to the Pension Trust Division of the National Office of the Internal Revenue Service, only 300 stock bonus plans were started from 1955 to 1970.

The lack of interest in stock bonus plans over the years can be attributed to several factors. Rules and procedures for establishing stock bonus plans varied from IRS District to IRS District. Also, any investments made by a stock bonus plan had to be for the "exclusive benefit of the employees"; yet, no clear guidelines existed for defining what would be the criterion for the "exclusive benefit of the employees."

The upsurge in interest in stock bonus plans can be traced principally to two key figures: Louis O. Kelso, a lawyer and lay economist, and coauthor of three books on the subject of people's capitalism; and Senator Russell B. Long, Chairman of the Senate Finance Committee, the driving force behind legislative proposals on ESOPs and Kelso's staunchest supporter.

But, of course, more than a desire on the part of Kelso and Long was required to inspire companies to share ownership—it took tax advantages created by the Employee Retirement Income Security Act of 1974 (ERISA), the Tax Reduction Act of 1975 and the Tax Reform Act of 1976. These acts offered a unique combination of retirement benefits and employer-company incentives in the form of ESOPs.

## New Direction to Capitalism?

By definition, under our economic system, investment in and ownership of the means of production, distribution and exchange of wealth are traditionally made and maintained by private individuals and corporations. In fact, on the basis of information released by the U.S. Department of Commerce, *51 percent of the value of all common stock is owned by only 1 percent of U.S. families, 75 percent of the value of all common stock is owned by only 10 percent of the country's shareholders, and 47 percent of all dividends paid by U.S. companies is received by only 1 percent of all U.S. families.*<sup>1</sup>

According to Kelso, Long and other economic theorists, dissatisfaction with the "system" is high among employees. *In a survey by Peter D. Hart Associates, only 17 percent favor the present economic system and 41 percent want major change.*<sup>2</sup>

<sup>1</sup>Marshall E. Blume, Jean Crockett and Irwin Friend, "Stockownership in the United States: Characteristics and Trends," *Survey of Current Business*, November 1974.

<sup>2</sup>*Wall Street Journal*, August 22, 1975, p. 1.

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## Straightening Out the Definitions

For many years the Internal Revenue Code has allowed favorable tax treatment to tax-qualified, defined-contribution employee benefit plans. In the narrow sense, tax qualified means that the employee benefit plan meets certain specified criteria regarding participation, vesting and the like. In the broader sense, however, tax qualified means that employer contributions to the plan are deductible by the company for tax purposes and are not taxable to the employee until actually distributed or made available to him. Also, tax on any income earned by the plan is similarly deferred. Defined contribution means that the ultimate benefits to the employee are based solely upon the amount contributed to a participant's account and upon any income, expenses, gains and losses allocable to the participant's account.

Prior to ERISA, the term ESOP—for employee stock ownership plan—was used broadly to refer to any type of tax-qualified, defined-contribution stock bonus plan. With ERISA, the term ESOP is no longer synonymous with “stock bonus plan.” A stock bonus plan is *permitted*, with limitations, to invest in qualifying employer securities, but an ESOP is *required* to invest *primarily* in qualifying employer securities. Also, an ESOP may purchase employer company stock from the employer or from majority or other shareholders, whereas a stock bonus plan is prevented from engaging in such transactions.

Beginning with the Tax Reduction Act of 1975, and as expanded by the Tax Reform Act of 1976, an additional type of ESOP was created, known as the investment-credit ESOP or TRASOP (for Tax Reduction Act stock ownership plan).

Three types of employee benefit plans fall under the major heading of employee stock ownership plans. They are:

ESOP—stock bonus plan—the “basic” plan

ESOP—stock bonus/money purchase plan—a variation of the “basic” plan

TRASOP—investment-credit plan—a plan with unique tax advantages

The tax advantages unique to the TRASOP allow a company to offer its employees benefits that cost it nothing except for certain administrative costs necessary for the operation of the plan. Because of this, many companies are becoming interested in TRASOPs, and this type of plan may be the form most often seen in the future.

Let's take a look at the basic operation of an ESOP and then look more closely at each of these definitions.

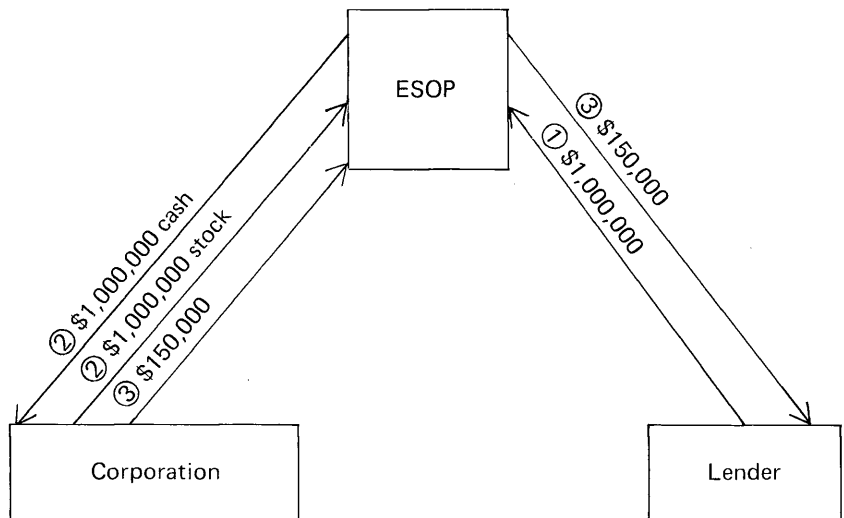


## Operation of an ESOP

The chief advantage that an ESOP has over other types of employee benefit plans is its ability to be used for corporate financing. It can be used in many different ways to accomplish differing objectives, depending on the circumstances confronting a company. An understanding of its basic operation is important here.

Assume a corporation needs to raise \$1,000,000. It might need these funds for additional capitalization, for purchase of a new building or equipment or for a variety of other reasons. The corporation can adopt an ESOP and have the ESOP borrow the \$1,000,000 from a lending institution. The loan is guaranteed by the corporation and is payable in ten equal annual instalments of \$150,000. The total interest for the ten-year period is \$500,000.

The ESOP uses the loan proceeds to purchase \$1,000,000 of newly issued stock from the corporation. The corporation then makes annual cash contributions, which are tax deductible, to the ESOP so as to enable the ESOP to retire the loan. The result is that the corporation received \$1,000,000 of new funds and also receives a tax deduction for the repayment of the loan. This series of transactions is illustrated in the following diagram:



1. ESOP borrows \$1,000,000 from a lender.
2. ESOP buys \$1,000,000 of stock from the corporation.
3. Corporation makes \$150,000 annual contribution to the ESOP which, in turn, makes an annual payment on the loan.

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Assuming a 50-percent corporate tax rate, the \$1,000,000 in new funds was obtained for \$500,000 (interest on the loan is not considered, since it would be deductible by the corporation if it had borrowed the funds directly).

In this example, the ESOP purchased the stock from the corporation because one of the corporation's objectives was to use the ESOP as a means of raising capital. With different objectives in mind, the ESOP could have purchased the stock from existing shareholders or on the open market.

The various advantages and disadvantages of ESOPs are discussed in later sections. Nevertheless, it is important to point out here that the basic operation of our ESOP will result in a broadening of a company's capital base. This broadening may result in a dilution not only of ownership of the present shareholders but also of the earnings of the company.

## **ESOP—Stock Bonus Plan**

An ESOP—stock bonus plan is the “basic” plan. It is designed to invest primarily in securities of the employer and to make distributions of these securities to the employee participants. Thus the participants are given a share in the ownership of the company for which they work.

At the same time as ownership is given to the employees, the employer company receives a tax deduction for its contribution to the plan. Moreover, if the employer contribution is in the form of stock, the deduction does not require a cash outlay.

**Qualifying Employer Securities.** Typically the employer securities used to fund the ESOP consist of the common stock of the employer. But other employer securities, such as bonds, debentures or other evidences of indebtedness, may be used, subject to certain restrictions.

**Use of Borrowed Funds.** A feature unique to an ESOP is its ability to borrow funds that are required to be guaranteed by either the employer company or a majority shareholder. This is a requirement often imposed by a lender. A profit-sharing, pension or stock bonus plan that is not an ESOP cannot engage in borrowing if either the employer company or the majority shareholder must act as guarantor.

It is not necessary for an ESOP to engage in financing, but the ability to do so offers special advantages to the company. As shown in the illustration, this capability allows the employer to receive the proceeds of the ESOP's loan (via purchase of employer securities by the ESOP with the borrowed funds), yet retire the loan with annual tax-deductible contributions to the ESOP.

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If an ESOP uses funds borrowed from or guaranteed by a “party in interest” to acquire employer securities, several specific requirements must be met:

- The loan must be for the primary benefit of the participants.
- The interest rate must be reasonable in the circumstances.
- The proceeds of the loan must be used within a reasonable time to acquire the employer securities, to repay the loan, or to repay a prior qualifying loan.
- The loan must be without recourse against the ESOP, although the employer securities acquired by the proceeds of or released as collateral from a prior qualifying loan that is repaid with the current loan may be used as collateral.
- Securities purchased with borrowed funds are encumbered and must be held in a suspense account (and not allocated to the employees’ accounts). As the loan is repaid, a prorata number of shares (based on total principal and interest to be repaid) are released from the encumbrance.

A “party in interest” includes, among others, the employer corporation and any employee, officer, director or 10 percent or more shareholder of the corporation.

Loans not made or guaranteed by a party in interest are not specifically subject to these requirements, but they are still subject to the requirement that they be made primarily for the benefit of participants and are subject to the normal fiduciary standards.

**Contributions to the ESOP–Stock Bonus Plan.** The Internal Revenue Code provides that the employer may deduct its annual contribution to the ESOP–stock bonus plan up to a limit of 15 percent of the total annual compensation of employees participating in the plan. Currently, the amount that can be added annually to the account of an individual participant is limited to the lesser of \$30,050 or 25 percent of that participant’s compensation. This \$30,050 is subject to an annual cost-of-living adjustment.

If the contributions are *less than* the 15-percent limitation, the remaining amount may be carried over to a succeeding year. The total amount deducted in the succeeding year is limited to 25 percent of that year’s covered compensation. If the contribution is *more than* 15 percent of the covered compensation, the unused amount is carried over to a succeeding year. However, the amount deducted in the succeeding year cannot exceed 15 percent of the succeeding year’s covered compensation.

An employee may be required or permitted to contribute to the plan, or both. If he or she contributes voluntarily, he may contribute up to 10 percent of his compensation. If he contributes as a requirement, the

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amount of contribution required is limited to a maximum of 6 percent of compensation. If he is both required and permitted to make contributions, he may contribute up to 16 percent of his compensation. Voluntary and required contributions are not deductible by the employee. However, any income on these contributions is not taxable to the employee until it is distributed or made available to him.

**Vesting of Benefits.** The rules for the vesting of participant benefits derived from employer contributions to ESOPs are the same as those prescribed by ERISA for employee benefit plans in general. These minimum vesting requirements may be satisfied through one of the following alternatives:

- Full vesting after ten years of service, with no vesting required prior to that time.
- A graduated vesting beginning with 25 percent after five years of service, 50 percent after ten years and full vesting after fifteen years.
- A graduated vesting beginning with 50 percent at the earlier of ten years of service or when the sum of age and years of service (five or more) totals forty-five. Annual increases of at least 10 percentage points for each year of service thereafter are required.
- A separate vesting of each year's employer contribution, with full vesting no later than five years after the close of the year for which the contribution was made.

The participant benefits derived from employee contributions, whether mandatory or voluntary, are always fully vested.

**Voting Rights.** Under the ESOP–Stock Bonus Plan voting rights may or may not be passed through immediately to the employee, depending on the particular provisions of the plan agreement. If the voting rights do not pass through immediately to the employee, an administrative committee appointed by the company's board of directors will usually vote the ESOP's shares. The members of the committee, of course, may include employee representatives. It is important, however, that the shares be voted solely in the interest of the employees.

**Distribution of Securities to Employees.** An ESOP must provide a definite, predetermined formula for distributing the securities held by it. The distribution may be made

- After a fixed number of years (at least two years)
- Upon reaching a stated age
- Upon occurrence of events such as layoff, illness, disability, retirement, death, or separation from service with the employer

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Unless the employee elects otherwise, distribution of the securities from the ESOP is *required* to begin within sixty days after the *latest* of

- Reaching age sixty-five (or normal retirement age if less than sixty-five)
- Participating in the plan for ten years
- Separating from service with the employer

**Right of First Refusal.** A right of first refusal gives the employer company the option to repurchase the securities if the employee, upon receipt of the securities, desires to sell or transfer any of his holdings to a third party. Securities acquired with funds borrowed from or guaranteed by a party in interest may be, but are not required to be, subject to this right only if they are in the form of stock or a security convertible into an equity security or other stock and they are not publicly traded at the time that the right is exercised. Having met these conditions, the right itself must meet certain requirements. For example:

- The right must be in favor of the employer, the ESOP or both.
- The selling price and other terms of the right must be at least as favorable as the greater of the value of the security determined by IRS Regulations or the price and terms offered by another buyer making a good-faith offer to purchase.
- The right must lapse no later than fourteen days after the security holder gives written notice that a third party has made an offer for the security.

**Put Option.** A put option allows the employee to require the company to purchase his securities at their fair market value as determined by IRS Regulations. Securities acquired by the ESOP with funds acquired from or guaranteed by a party in interest must be subject to a put option if they are not publicly traded or are subject to a trading restriction under federal or state securities laws when the securities are distributed.

The option must have a life of at least fifteen months beginning when distribution is made from the ESOP. The option must bind the company only. Under no circumstances can it bind the ESOP. However, the option may allow the ESOP to assume the company's rights and obligations. In order to ease the demand that can be placed on a company's cash requirements, the Regulations generally provide for instalment payments over a period of not more than five years from the exercise date. However, the period may be extended to up to ten years.

**Call Option and Buy-Sell Agreement.** A call option allows the company to require the employee to sell his securities at their fair market value to either the company or the ESOP. A buy-sell agreement obligates the company or the ESOP to purchase company securities owned by a shareholder at the death of the shareholder. Securities acquired with funds borrowed from or guaranteed by a party in interest may not be subject to a call option, buy-sell agreement or similar arrangement.

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## **ESOP–Stock Bonus/Money Purchase Plan**

The definition of an ESOP under ERISA also includes a “plan... which is... a stock bonus and a money purchase plan both of which are qualified....”

A money purchase plan is a defined contribution plan. The annual contribution is fixed usually at a flat dollar amount or at a percentage of compensation of the participating employees. The amount of the employee's benefit on retirement depends upon the investment performance of the fund. The ultimate benefit will be that which can be purchased with the employee's interest in the fund.

When a money purchase plan is combined with a stock bonus plan in an ESOP, the characteristics of the money purchase plan and stock bonus plan are essentially maintained. There is one important difference, however. Contributions up to 25 percent of the total annual compensation of participating employees can be deducted for tax purposes.

## **TRASOP–Investment-Credit Plan**

With the Tax Reduction Act of 1975 a new type of stock ownership plan with special advantages was created. The Tax Reform Act of 1976 expanded these advantages. This type of stock ownership plan has come to be known as a TRASOP (for Tax Reduction Act stock ownership plan).

The unique feature of the TRASOP is that a company is allowed an additional 1-percent investment tax credit if such additional amount is contributed to the TRASOP. Up to another ½-percent investment tax credit is allowed if the amount is contributed by the company to the TRASOP and the employee participants contribute a matching amount.

But TRASOPs are not just regular ESOPs with additional fringe benefits. They may be a separate alternative to be used solely for investment-tax-credit purposes without other ESOP functions. This approach has the advantage of allowing a company to receive a tax credit, which costs the company nothing in terms of a direct economic cost, as compared with a tax deduction for contributions to an ESOP, which does result in a direct economic cost to the company.

As an example, assume a company annually spends \$10 million for additions of plant and equipment that qualify for investment-tax-credit purposes. This means that the additional 1-percent investment tax credit will amount to \$100,000. If the company has 500 employees participating in the ESOP, an average of \$200 per employee may be contributed to the plan. *This amount is funded entirely by the U.S. government; it costs the employer absolutely nothing beyond the administrative costs associated with the operation of the plan.*

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**Contributions.** The only securities that may be contributed to the TRASOP are common stock of the employer or securities that are convertible into common stock. The stock must have voting rights and dividend rights no less favorable than those of other common stock of the employer.

Cash contributions are also allowed if the cash is used to purchase employer securities within thirty days following the due date (including any extensions of time) for filing the company's income tax return for the taxable year during which the qualified investment is made.

**Requirements of a TRASOP.** Features unique to a TRASOP as compared with an ESOP are as follows:

- Participants must be entitled to vote the stock allocated to their account and to direct the conversion of any convertible securities held in their account.
- The plan must provide for immediate and full vesting each year. Forfeitures are prohibited.
- All employer securities transferred to or purchased by the plan must be allocated to participants' accounts substantially in proportion to the participants' compensation, disregarding compensation in excess of \$100,000.
- Except for death, disability or separation from service, participants cannot receive any distributions of securities unless they have been held for at least eighty-four months from the date of allocation to their account.
- A company is allowed to recover from a TRASOP the securities representing the additional investment credit where the investment credit is recaptured because of early retirement of property or where it is reduced because of a redetermination of the company's income or investment in property qualifying for investment credit. However, in order to do so, the securities representing each year's additional contribution must be separately accounted for and segregated from other plan assets.

**Special Requirement for Public Utilities.** The Tax Reform Act of 1976 intended that the entire additional amount of the investment credit go to the TRASOP. If a public service commission requires that a utility flow through any part of the additional credit to the consumer, the entire amount of the additional investment credit will not be allowed to the company.

### **Conversion of a Profit-Sharing Plan into an ESOP**

Properly structured, an existing profit-sharing plan can be converted into an ESOP. But a pension plan cannot be converted into an ESOP without incurring the substantial risk that the Internal Revenue Service might disallow all prior tax deductions for contributions to the pension plan.

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There are two potential advantages to converting an existing profit-sharing plan into an ESOP. One potential advantage is that the unused contribution carryover, which is the cumulative amount of allowable contributions to the profit-sharing plan in excess of contributions actually made, can be carried forward to the ESOP. This carryforward will increase the allowable contribution for subsequent years from 15 percent of the compensation of participating employees to as much as 25 percent of such compensation.

The second potential advantage is that the assets in the profit-sharing plan may be used to acquire qualifying employer securities from the company, thereby providing the company with a source of funds. Some district directors of the IRS, however, have not allowed the funds in a profit-sharing plan to be used to acquire company securities and have insisted that these funds be kept separate from other ESOP funds. It is hoped that this inconsistency in policy will be resolved to allow the assets from the profit-sharing plan to be used to acquire company securities, provided that the investment is prudent for the ESOP. The so-called "prudent-man" rule for the evaluation of investments is an important matter when considering the adoption of any ESOP. It is a particularly important matter in the conversion of a profit-sharing plan into an ESOP.

### **Accounting and Financial Reporting**

In December 1976 the Accounting Standards Division of the American Institute of Certified Public Accountants issued a Statement of Position on "Accounting Practices for Certain Employee Stock Ownership Plans." The statement was intended to help resolve some of the accounting and reporting issues that have arisen as a result of the legislation that created and defined ESOPs and TRASOPs.

The Statement's recommendations include:

- Recording in the financial statements of the employer company the obligation to guarantee ESOP loans and/or a commitment to make future contributions to the ESOP in sufficient amounts to meet the loan repayment schedule. The obligation should be recorded as a liability with an offsetting reduction in shareholder's equity.

The amount of liability and offsetting reduction in shareholders' equity is reduced as the ESOP makes payments on the debt.

The assets held by the ESOP should not be recorded in the financial statements of the employer company.



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- Charging to expense the amount contributed or committed to be contributed to an ESOP in a given year.

Reporting separately the compensation element and the interest element of the annual contribution to the ESOP.

- Treating all shares held by an ESOP (whether distributed to employees or not) as outstanding shares in the determination of earnings per share.

Charging against retained earnings dividends paid on shares held by an ESOP. These dividends should not be recorded as compensation expense.

- Accounting for the additional investment tax credit (allowed through the establishment of a TRASOP) as a reduction of income tax expense in the same year that the contribution to the ESOP is charged to expense, irrespective of the accounting for the normal investment tax credit on property acquisitions.

A significant minority within the Accounting Standards Division believes that the entire annual contribution should be reported as compensation expense. Also, a minority believes that shares should be considered outstanding for earnings-per-share calculations only to the extent that they become constructively unencumbered by repayments of debt principal.

### **Securities Law Considerations**

Because the operations of an ESOP include the offer or sale of securities, care must be taken to ensure compliance with federal and state securities laws.

The interests of the employees in the ESOP and the employer securities that the ESOP acquires may be considered to be securities requiring registration under the Securities Act of 1933 unless an exemption is available. In addition, purchases or sales by the ESOP of employer securities involve questions of the possible illegal use of nonpublic information. In certain situations, such as in a plan with an option for employee contributions, exemption from registration is probably not available. For these and other reasons, obtaining appropriate legal counsel and accounting expertise is extremely important when consideration is first being given to the formation of an ESOP.

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## **Advantages and Disadvantages of ESOPs**

There are three vantage points from which to consider the advantages and disadvantages of ESOPs—the employer company, the major shareholder(s) and the employees for whom the plans were originally developed.

### **Advantages to Employer Company**

- ESOPs are the only deferred-compensation plans that can be used as a means of corporate finance. When leveraging is used by the ESOP to purchase employer securities from the company, the company receives an infusion of cash as if it had borrowed directly from a lender; however, the loan is repaid with tax-deductible contributions.
- ESOPs help to instill in the employee a sense of identity with the company.
- Contributions to the ESOP may, in turn, either create or increase a taxable loss which can be carried back or forward in normal fashion. Thus a noncash item in the form of a contribution of stock can result in a refund of prior taxes paid or in the reduction of future tax liabilities.
- If the marketability of a company's stock is limited, as with privately or closely held companies, the ESOP can provide a needed market for the stock.
- ESOPs can be used as a means to finance acquisitions of other companies.
- ESOPs may also be used in corporate divestitures to spin off a division or a subsidiary to employees.
- Congress presently appears to be encouraging ESOPs through tax incentives. The 1- to 1½-percent additional investment tax credit allowed TRASOPs is an example. Such incentives provide the company with a means of providing employee benefits at little or no extra cost.

### **Disadvantages to the Employer Company**

- ESOPs are required to invest primarily in employer securities. This results in the retirement benefits of employees being tied primarily to the performance of a single security. Since employees may not fully understand possible changes in profitability and the effect on stock prices, employee unhappiness may result in the company being pressured to provide other benefits.
- If the company issues new stock to the ESOP, any dividends paid on the stock will reduce and possibly eliminate the advantage of the repayment of the ESOP debt with tax-deductible funds.

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- Contributions to an ESOP are charged to expense which, unless offset by earnings on increased cash flow, will result in a dilution of earnings per share and of book value per share.
  - Contributions of stock to an ESOP will also result in a dilution of value to present owners, especially if contributions are made at times when the market value of the stock is low.
  - The voting power that an ESOP may develop, as more and more stock is held by the ESOP, can cause difficulties for company management. Members of the ESOP administrative committee, who vote the stock, are often principals of the employer, but they must vote the stock solely in the interest of the employees. This interest may, at times, be different from that of the employer or other shareholders.
  - The interests of the employees in the ESOP and the employer securities that the ESOP acquires may be considered to be securities requiring registration under the Securities Act of 1933 unless an exemption is available.
  - Terminating employees, a large number of layoffs, or the death of a principal employee with a large interest in the ESOP may place an unexpected demand on the ESOP for liquidity. While it may be allowable for the ESOP to maintain funds to satisfy this type of contingency, it may be impossible or impractical to do so. A put option with a long payout period will help to mitigate the impact of such demands.
  - If a company is closely held, determining the value of the stock to be contributed to or purchased by the ESOP can be difficult. If the valuation is found to be in error by the IRS, deductions for previous contributions may be reduced and significant penalties levied.
  - Unless a company has a sizeable payroll (due to the limitation based on the total annual compensation of participating employees) or makes sizeable capital improvements (the additional investment tax credit allowed through the use of a TRASOP), the amount of the contribution to the ESOP may be so small as to negate the use of the ESOP as a means to retire debt with tax-deductible dollars.
  - For similar reasons (size of payroll and amount of capital improvements), the portion of the annual contribution that is allocated to a participant's individual account may not be significant enough to justify the administrative costs.
  - As with other employee-benefit plans, an ESOP cannot be terminated without possible penalties to the company and the participating employees.

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### **Advantages to Major Shareholder(s)**

- An ESOP can provide a much-needed market for the stock held by a major shareholder or his estate.
- An ESOP can redeem the shares of a major shareholder using tax-deductible dollars contributed by the company. If the company itself were to redeem the shares, no deduction for tax purposes would be available.
- A sale of stock to the ESOP by a controlling shareholder may qualify for capital-gains treatment under circumstances where the proceeds from the sale to the company would otherwise result in treatment as dividend income.
- Insurance premiums on key-man life insurance are not normally fully deductible for tax purposes. An ESOP can be used to convert these premiums into deductible payments if the proceeds of the insurance policy are made payable to the ESOP to fund a put option of the shareholder's estate.

### **Disadvantages to Major Shareholder(s)**

- While an employee may have a put option,<sup>3</sup> the company is allowed only a right-of-first-refusal option; call options are not permitted. This means that ownership of a closely held company may become more widespread, absent exercise of any put option by the employee. This dilution in ownership may not be consistent with the wishes of the major shareholders.
- Borrowing funds through an ESOP may result in increased cash flow and higher earnings per share than regular debt financing if a company replaces a present employee benefit plan with an ESOP. But the dilution in ownership may not be worth the increase in cash flow.
- The major shareholder is likely to be a member of the administrative committee of the ESOP. One of the responsibilities of the committee is to ensure that the ESOP purchases the employer securities at a fair price. The major shareholder may face the unwelcome situation of having to disclose to others information concerning his personal financial matters that might not otherwise be made public.

<sup>3</sup>As discussed on page 11, put options are required where securities are purchased with funds borrowed from or guaranteed by a party in interest and are not publicly traded or have certain limitations on trading.

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### **Advantages to Employees**

- Participation in an ESOP changes the role of the employee—from that of a wage earner to that of an owner with a “piece of the action.” The ESOP provides a form of continual profit sharing not only at the time of contribution but also through the benefits of stock ownership—cash dividends and, hopefully, market appreciation of the stock.
- An ESOP is usually capable of acquiring a larger block of stock “up front” than an employee on his own. This is especially the case when the ESOP is used as a financing tool (company sells a large block of stock to the ESOP initially and retires the ESOP’s debt over a period of time). Thus the employee enjoys the possibility of greater appreciation in the stock value because of the leverage achieved through ESOP financing.
- The employee is not taxed on the contributions to the ESOP or the income received by the ESOP until such time as these amounts are distributed or made available to the employee.
- “Lump-sum distributions” of securities are taxed in the year the distribution is made at the value originally assigned to the securities at the time of their contribution to the ESOP. Any appreciation in the value of the securities will receive capital-gain treatment and is not taxed until subsequently sold by the employee.

### **Disadvantages to Employees**

- In a smaller company, the ESOP may be the only retirement benefit for employees. Tying the retirement security of employees so closely to the success or failure of the company may not be viewed by them as a sound decision.
- Small fluctuations in the market price of the stock will have a dramatic effect on an ESOP that uses leveraged financing. If the ESOP purchased the company stock with 10 percent of its own funds and 90 percent borrowed funds, a 10 percent drop in the market price would virtually eliminate the employee’s equity in the plan.
- A plan may require an employee to make contributions (up to 6 percent) from his after-tax income. This may be difficult for some employees to accomplish.

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## **A Final Thought**

Employee stock ownership plans are here to stay. More and more companies are joining the ranks of those who recognize the unique opportunities that ESOPs offer. And Congress seems to be in the mood to foster these plans. In addition to the Employee Retirement Income Security Act of 1974, the Tax Reduction Act of 1975 and the Tax Reform Act of 1976, all of which defined and clarified ESOPs, Congress has before it further proposed legislation concerning ESOPs, including the Accelerated Capital Formation bill. This bill would remove the limit on employer contributions to an ESOP and make dividends paid on ESOP-held stock tax deductible to employers.

In this booklet we have attempted to clarify some of the finer points of ESOPs and to provide a level of insight into their potentialities. A careful analysis should be made of the advantages and disadvantages in each situation. A thorough understanding of the long-range implications is necessary because an ESOP, as with many employee benefit plans, cannot be terminated without possible penalties to the company and the participating employees. But at its heart, an ESOP can operate for the benefit of the company, its employees and its shareholders.

